INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Law A =

State B =

Company C =

Company D =

a =

b =

c =

ISSUE: Are the competitive transition charges and intangible transition charges collected by the Taxpayer, nontaxable as nonshareholder contributions to capital under § 118(a)?

CONCLUSION: The competitive transition charges and intangible transition charges collected by the Taxpayer constitute income under § 61 and not contributions to capital under § 118(a).

FACTS:

On a, Law A was signed into law in State B. Under Law A, retail customers are able to contract directly with alternative suppliers of electricity (generation), while transmission and distribution remained regulated. Prior to deregulation, Company C, a subsidiary of Taxpayer was involved in the generation, transmission, and distribution of electricity. Currently, Company C operates only a transmission and distribution system in State B. Company C transferred its generator assets to an LLC of its parent holding company, Company D.

As required by Law A, Company C was required to submit to the Public Utility Commission ("PUC") restructuring plans that addressed, inter alia, the utility's "stranded costs". Stranded costs are the electric utility's generation-related costs (e.g., investment in generating plants, nuclear decommissioning costs, and long-term purchased power commitments, etc.) after mitigation, which traditionally would have been recoverable under a regulated environment, but which might not be recoverable in a competitive electric generation market.

The stranded costs, after approval by the PUC, are to be collected from all of Company C's distribution customers through a non-by-passable competitive transition charge (CTC) (i.e., customers pay even if they are utilizing other generation providers). The CTC appears on all customers' bills for service rendered on or after b through c. The total amount of stranded costs to be collected was allocated among the customer classes (residential, commercial, and industrial) per rate schedule based upon historic cost of service studies for these customer classes. In other words, the amount of CTC to be collected from each customer class was based upon past cost of service.

As a mechanism for the mitigation of CTCs and the reduction of customer rates, the Law A authorizes an electric utility to securitize its stranded costs through the issuance of bonds (transition bonds) either directly by the utility, or by a finance subsidiary or third party. Once the transition bonds are issued, the utility collects from the distribution customers non-by-passable intangible transition charges (ITCs) over a finite number of years, to service the costs associated with the transition bonds (principal, interest, fees, credit enhancements, etc.).

The Taxpayer asserts that the transition charges (CTC and ITC) qualify as non-shareholder contributions to capital under § 118(a), citing the benchmark test established in U.S. v. Chicago, Burlington, & Quincy RR Co., 412 U.S. 401 (1973). The revenue agents for the Internal Revenue Service assert that the CTCs and ITCs represent compensation for electrical services and thus income under § 61.[1]

LAW AND ANALYSIS:

Section 61(a) and section 1.61-1 of the Income Tax Regulations provides that gross income means all income from whatever source derived, unless excluded by law.

Section 118(a) provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 118(b) provides that for purposes of subsection (a), except as provided in subsection (c), the term "contribution the capital of the taxpayer" does not include any contribution in aid of construction ("CIAC") or any other contribution as a customer or potential customer.

Section 1.118-1 of the Income Tax Regulations provides, in part, that section 118 applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a government unit or by a civic group for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid to induce the taxpayer to limit production (emphasis added).

Notice 87-82, 1987-2 C.B. 389, provides additional guidance on the treatment of CIACs. Notice 87-82 provides that a payment received by a utility that is not reasonably related to the provision of services by the utility or for the benefit of the public at large, is not a CIAC. In Notice 87-82, an example of a payment benefitting the public at large is a relocation payment received by a utility under a government program to place utility lines underground. In that situation, the relocation is undertaken for either reasons of community aesthetics or in the interest of public safety and does not directly benefit particular customers of the utility. Notice 87-82 states that in other cases, however,

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1. The issue for our consideration is a different one from the issue raised in TAM 200347014. In TAM 200347014, the issue is whether a utility may exclude certain gains from the sale of assets from gross income when the utility is under a legal obligation to pay such amounts to its customers. In contrast, the issue in the present case is whether certain payments made by the utility's customers to the utility may be excluded from the income of the utility.

relocation fees are treated as CIACs and included in gross income because they relate to the provision of services by the utility to or for the benefit of the person making the payment.

The Supreme Court has also provided guidance concerning the dichotomy between capital contributions and income in exchange for the performance of services. In Detroit Edison v.Commissioner, 319 U.S. 98 (1943), the Court considered whether payments by customers to an electric utility company for extending the utility's services to customers' homes constituted capital contributions rather than taxable income. In concluding that the payments were taxable income and not capital contributions, the Court stated: "It is enough to say that it overtaxes the imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The transaction neither in form nor in substance bore such a semblance. The payment were to the customer the price of the service" 319 U.S. at 102-103.

Later, the Court held that payments to a corporation by community groups to induce the location of a factory in their community represented a contribution to capital Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950). The Court concluded that the contributions made by the citizens were made without anticipation of any direct service or recompense, but rather with the expectation that the contribution would prove advantageous to the community at large. The Court reasoned:

> Since in this case there are neither customers nor payments for service, we may infer a different purpose in the transactions between petitioner and the community groups. The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Upon these circumstance the transfers manifested a definite purpose to enlarge the working capital of the community. Brown Shoe Co., 339 U.S. at 591 (emphasis added).

Finally, in United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. 401 (1973), the Court considered whether a taxpayer was entitled to depreciate the cost of certain improvements including highway undercrossings and overcrossings, crossing signals, signs, and floodlights, that had been funded by the Federal Government. The Court held that the government subsidies were not contributions to the taxpayer's capital. In considering the precedent of Brown Shoe and Detroit Edison, the Court identified the salient characteristics of a nonshareholder contribution to capital under the Internal Revenue Codes of 1939 and 1954:

1. It must become a permanent part of the transferee's working capital structure;

2. It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee;

3. It must be bargained for;

4. The asset transferred must forseeably result in benefit to the transferee in an amount commensurate with its value; and

5. The asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

In reaching its conclusion in CB&Q that the improvement at issue did not qualify as contributions to capital, the Court reasoned:

> Although the assets were not payments for specific, quantifiable services performed by CB&Q for the Government as a customer, other characteristics of the transaction lead us to the conclusion that, despite this, the assets did not qualify as contributions to capital. The facilities were not in any real sense bargained for by CB&Q. Indeed, except for the orders by state commissions and the government subsidies, the facilities would not have been constructed at all. CB&Q, 412 U.S. at 413-414.

The Taxpayer argues against the applicability of § 118(b) in the present case. The Taxpayer cites to Notice 87-82 for the position that stranded cost recoveries resulted in no direct benefit to the utility customers, but rather were mandated by the State B Legislature as a means of facilitating the public good of enhancing competition among electrical generation utilities.

In arguing for the applicability of § 118(a) treatment for the stranded costs, the Taxpayer emphasizes that the real contributor in this case is State B, not the utility customers, as demonstrated by its legislative intent to make a contribution, via the recovery of stranded costs, benefiting all citizens in State B. According to the Taxpayer, the right to recover stranded costs represents a specific and unique contribution from State B to encourage and facilitate viable competition among electrical generation utilities for the public good rather than compensation for specific services under the CB&Q test.

In addition, the Taxpayer asserts that although the amounts are collected from current customers, this circumstance, in and of itself, does not make these recoveries compensation for services rendered. Although the liability is recovered from customers of a tariffed rate class as a whole based upon a flat kilowatt per hour basis (i.e., allocated to each bill on a kilowatt hour usage basis), this amount has nothing to do with the services being provided to those customers. Rather, the Taxpayer asserts that the liability was a negotiated amount that was determined to be sufficient to bridge the Taxpayer and other utilities from regulation to competition by reimbursing the Taxpayer and others for past capital investments made in generation related assets. Taxpayer asserts that electric utility customers are paying an allocated amount on behalf of State B for the right to have a choice of generation suppliers and for the benefit of an economic asset that the Taxpayer had the right to exercise. The Taxpayer also emphasizes the fact that the charge on the customers' bills are non-bypassable, meaning that even if a customer switched to an alternative power generator, the Taxpayer would still enforce stranded cost recoveries from the entire tariffed class of customers including the customer that switched providers, notwithstanding the fact that the customer was being served by a different generation provider. Moreover, the charges are separately stated, recoverable over a 10-year period, and have priority in collection.

In examining other enunciated factors in CB&Q, the Taxpayer argues that the CTCs and ITCs are the result of bargaining. Specifically, the Taxpayer asserts that the public hearing, the in-depth discussions and bargaining between the Taxpayer and the PUC, and the ultimate nature of the final agreement with respect to the stranded cost recoveries all exemplify the negotiation involved.

The IRS revenue agents maintain that the CTC and ITC charges collected by Taxpayer from its customers are simply for utility service imposed upon Taxpayer's jurisdictional customers. Payment is a condition to the provision of service. Service is terminated if the utility bill, which includes these charges is not paid. The CTC charges are approved by the PUC under its traditional rate-making authority.

Under § 118(b), the revenue agents argue that the CTC/ITC payments were made by the jurisdictional transmission and distribution customers of the Taxpayer as customers, and for no other reason. The plain language of section 118(b) clearly excludes from capital contribution treatment CIAC "or any other contribution as a customer or potential customer." The revenue agents note that the payments made to the utility reasonably related to the provision of services by the utility to or for the benefit of the person making the contribution: the customer. See Teleservice Company of Wyoming Valley v. Commissioner, 254 F.2d 105 (3rd Cir. 1958), aff'g, 27 T.C. 722 (1957) (contributions for construction of community television system were made by customers).

In applying the factors under CB&Q to the CTC and ITC, the revenue agents assert that the CTC/ITC payments are compensation for services provided by the utility to the customers. The CTC/ITC is collected based on usage charges, although the allocation of the CTC that is to be collected from rate schedules depends upon past costs of service to those rate schedules. Further, the customers' bills explicitly provide that the CTC and the ITC: "are not new charges. These were previously included in the generation charges on your bill". Additionally, the revenue agents note that the payments in reality constitute access charges to the Taxpayer's transmission and distribution system: no utility customer will receive electric service without making these payments.

The revenue agents also reason that the CTC/ITC charges were not bargained for. While there was a restructuring process with public hearings and the intervention of interested parties, neither the utility nor the customers could be viewed as bargaining. The revenue agents reason that the restructuring process was simply the administrative hearing required by due process when the PUC exercised its legislatively delegated ratemaking authority.

CONCLUSION

We strongly agree with the revenue agents' position that the stranded cost payments do not qualify as nonshareholder contributions to capital under § 118(a). Section 118(b) expressly provides that contributions made by a customer do not qualify under § 118(a). The stranded cost payments clearly come within the ambit of § 118(b) since the payments for the stranded costs are made by the customers as customers of the Taxpayer.

Additionally, since the payments are required to be made by the utility's customers to gain access to the utility transmission and distribution system, regardless of the source of the generation service, the payments are effectively rate payments for access to the utility's electrical services. If the payments are not furnished, electrical service will be denied. Indeed, the payments are calculated through a rate methodology very akin to tradition rate-making (i.e., amount based on usage).

Further, the payments are clearly not bargained for by the Taxpayer, but are part of the rate structure required under Law A. We also note that the customers making the payments are the same customers both before and after de-regulation. Finally, we believe that the utility customers do not have the requisite intent to contribute to the capital of the Taxpayer. Rather, the customers, and not State B, made the CTCs and ITCs payments in order to obtain electrical service from the Taxpayer.

For all these reasons, we conclude that both the CTCs and ITCs constitute income to the Taxpayer under § 61, and not contributions to capital under § 118(a).

CAVEAT:

A copy of this technical advice memorandum is to be given to the Taxpayer.
Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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